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# Message Text

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ACTION EUR-12

INFO OCT-01 ISO-00 AID-05 CIAE-00 COME-00 EB-07 FRB-01
INR-07 NSAE-00 USIA-15 TRSE-00 XMB-04 OPIC-06
SP-02 LAB-04 EPG-02 SIL-01 OMB-01 NSC-05 SS-15
STR-04 CEA-01 /093 W
----------171822Z 043094 /47
R 171709Z MAY 77
FM AMEMBASSY OTTAWA
TO SECSTATE WASHDC 3492
INFO USMISSION OECD PARIS
AMCONSUL MONTREAL
ALL OTHER CONSULATES IN CANADA (BY POUCH)

UNCLAS SECTION 01 OF 02 OTTAWA 03978

PASS TREASURY, FRB

E.O. 11652: N/A
TAGS: EFIN, CA
SUBJECT: POLICY REVIEW BY BANK OF CANADA GOVERNOR

REF: OTTAWA 3782

1. SUMMARY. RECENT REMARKS BY BANK OF CANADA GOVERNOR GERALD BOUEY JUSTIFYING RECENT BANK RATE REDUCTION REITERATED VIEW THAT EXPECTATIONS OF INFLATION MUST BE REDUCED TO STEM MOMENTUM OF WAGE AND PRICE INCREASES WHICH HAVE LED TO HIGH UNEMPLOYMENT AND LOSS OF MARKETS. GRADUAL REDUCTION OF MONEY SUPPLY INCREASE CONTINUES PART OF STRATEGY TO REDUCE SUCH EXPECTATIONS, BUT LATEST BANK RATE REDUCTION WAS TO PREVENT MONEY SUPPLY INCREASES FROM DECLINING TOO FAST. END SUMMARY.

2. IN REMARKS IN HALIFAX MAY 12, GOVERNOR BOUEY OUTLINED CURRENT BANK OF CANADA ECONOMIC STRATEGY IN THE CONTEXT OF THE LATEST BANK RATE DECREASE (REFTEL). WHILE MOST UNCLASSIFIED

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OF IT HAS BEEN SAID BEFORE, IT PROVIDES A USEFUL POLICY SUMMARY.

3. BOUEY SEES MOST OF CANADA'S PROBLEMS OF UNEMPLOYMENT, SLUGGISH GROWTH, AND CURRENT ACCOUNT DEFICITS AS ROOTED PRIMARILY IN INFLATION. STUBBORN UNDERLYING INFLATION RATE IS BASED ON PUBLIC SKEPTICISM THAT ANTI-INFLATIONARY

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POLICIES WILL BE PURSUED LONG ENOUGH TO BE SUCCESSFUL,
LEAVING EXPECTATION THAT INFLATION IS HERE TO STAY.
THIS HAS PRODUCED RATES OF INCREASE (NOT JUST NOMINAL
LEVELS) OF WAGES AND PRICES WHICH ARE DOWNWARDLY RIGID,
DESPITE HIGH UNEMPLOYMENT AND SLOW GROWTH.

4. EXPANSIONARY MONETARY AND FISCAL POLICIES IN HIS VIEW
WOULD ONLY GENERATE STRONG EXPECTATIONS OF HIGHER INFLATION.
ANY DOWNWARD FLOAT OF THE EXCHANGE RATE THAT WENT FAR
ENOUGH AND FAST ENOUGH TO MAINTAIN OR INCREASE CANADIAN
COMPETITIVENESS IN FOREIGN MARKETS WOULD GIVE ONLY A
TEMPORARY ADVANTAGE WHICH WOULD SOON BE LOST AS DOMESTIC
INFLATION GAINED MOMENTUM.

5. MONETARY AND FISCAL POLICIES PLUS WAGE AND PRICE
CONTROLS HAVE AVOIDED OVER-STIMULUS OF DEMAND AND BROUGHT
INFLATION DOWN TO ITS PRESENT LEVELS. AFTER CONTROLS
ARE LIFTED, TRADITIONAL MONETARY AND FISCAL POLICY
INSTRUMENTS WILL BE NECESSARY BUT NOT SUFFICIENT TO
REDUCE INFLATION AND RESTORE HEALTH TO THE ECONOMY.
ACKNOWLEDGEMENT OF PUBLIC CONFIDENCE THAT INFLATION IS
REALLY ON THE WANE WILL REQUIRE UNDERSTANDING AND
COOPERATION BY ALL GROUPS IN THE ECONOMY AND RECOGNITION
THAT UNDUE INCREASES IN THE PRICE OF LABOR AND OUTPUT
ENDANGERS JOBS AND MARKETS.

6. BOUEY SAID THE BANK OF CANADA "IS FIRMLY COMMITTED
TO A POLICY OF GRADUALLY LOWERING THE RATE OF GROWTH
OF THE MONEY SUPPLY OVER TIME" IN ORDER TO BE CONVINCING
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THAT EXPECTATIONS OF CONTINUED RAPID INFLATION ARE
UNFOUNDED. HE REPEATED THE WARNING IN THE BANK'S
ANNUAL REPORT THAT NO ONE SHOULD EXPECT RAPID MONETARY
EXPANSION TO ACCOMMODATE A FUTURE OUTBREAK OF LARGE
WAGE AND PRICE INCREASES. HOWEVER, LOWER RATES OF
MONETARY EXPANSION INVOLVE PAINFUL ADJUSTMENTS AND
ATTEMPTS TO MAKE ADJUSTMENT TOO RAPIDLY (READ: BELOW
CURRENT TARGETS) COULD BE INTOLERABLY DISRUPTIVE.
GIVEN THAT M-1 WAS BELOW TARGET AND THE POOR PREVAILING
ECONOMIC CONDITIONS, THE BANK RATE WAS REDUCED.

7. BOUEY NOTED WORLD ECONOMY IS NOW LESS INFLATIONARY
THAN A YEAR OR TWO AGO, AND EXPANSION HAS REVIVED,
ESPECIALLY IN THE U.S. THIS EXPANSION AND THE LOWER
EXCHANGE RATE WILL HELP CANADIAN EXPORTS THIS YEAR,
BUT NO SUSTAINED GROWTH AT RATES UP TO CANADA'S
POTENTIAL CAN BE EXPECTED AS LONG AS CANADIANS TRY
TO PAY THEMSELVES MORE THAN THEY EARN. HE FELT THERE
WAS A GROWING RECOGNITION OF THIS FACT.

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8. COMMENT. BOUEY'S REMARKS, WHILE DESIGNED TO JUSTIFY THE BANK RATE REDUCTION AND GIVE REASSURANCE THAT THE BANK HAS NOT MODIFIED ITS ANTI-INFLATIONARY STANCE, ALSO UNDERLINE FACT THAT BANK OF CANADA IS STILL LOOKING AT M-1 AS ITS KEY POLICY TARGET FOR INFLUENCING DOMESTIC ECONOMIC CONDITIONS, RATHER THAN AT INTEREST RATES PER SE OR EXCHANGE RATE TARGET. YET AS BOUEY REMARKED, LOWER RATES ARE VERY DESIRABLE GIVEN THE DEGREE OF SLACK IN THE ECONOMY. ANY FURTHER REDUCTION IN THE BANK RATE WOULD APPEAR TO DEPEND ON THE PROGRESS AGAINST INFLATION,

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WHICH COULD LEAD TO LOWER M-1 TARGETS AND ON THE RATE OF GROWTH OF M-1 ITSELF. ENDERS

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**Subject:** POLICY REVIEW BY BANK OF CANADA GOVERNOR
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**Review Markings:**
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